IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-1724

HARRY G. BURKS, JR., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

BRIEF OF INVESTORS DIVERSIFIED SERVICES, INC., AS *AMICUS CURIAE*

JOHN E. TOBIN
ROGER W. KAPP
RICHARD H. SAYLER
ROBERT J. SIVERD
Attorneys for
Investors Diversified Services, Inc.
30 Rockefeller Plaza
New York, New York 10020

DONOVAN LEISURE NEWTON & IRVINE

JOSEPH F. GRINNELL
Senior Vice President and General Counsel
Investors Diversified Services, Inc.

Of Counsel

TABLE OF CONTENTS

PAGE

Interest of the *Amicus Curiae* 1

Opinions Below 2

Questions Presented 2

Statutes and Rules Involved 3

Statement of the Case 3

Summary of Argument 9

Argument:

I. The Decision of the Court of Appeals Improperly Preempts Basic State Law Principles Concerning the Management of Corporate Affairs 12

II. The Decision of the Court of Appeals That the Independent Quorum Was Presumptively Disqualified From Exercising Its Business Judgment Threatens To Expand Greatly Shareholder Derivative Litigation in the Federal Courts 23

A. The Court of Appeals' Presumption Is Inconsistent With the Current Trend To Add Significant Numbers of Outside Directors to Corporate Boards and To Rely More Heavily on Them 24

B. The Court of Appeals' Presumption Improperly Permits Putative Shareholder Derivative Plaintiffs To Avoid Intracorporate Resolution of Disputes 27

C. The Presumption Has No Factual or Logical Basis 35

PAGE

D. The Court of Appeals' "Frivolous Case" Exception to Its Rule of Presumptive Disqualification Is Not An Adequate Substitute For the District Court's Careful Factual Inquiry Concerning the Independent Quorum's Decision .. 39

III. The Court of Appeals Misconstrued Provisions of the Investment Company Act Governing the Duties of Mutual Fund Independent Directors 48

CONCLUSION 54

ADDENDUM 1a

TABLE OF AUTHORITIES

Cases:

Abrams v. Mayflower Investors, Inc., 62 F.R.D. 361, 368-70 (N.D. Ill. 1974) 29n

Ashwander v. Tennessee Valley Authority, 297 U.S. 288, 343 (1936) 34, 45

Auerbach v. Bennett, 64 A.D.2d 98, 408 N.Y.S.2d 83 (2d Dept. 1978) 32, 42, 44

Baffino v. Bradford, 57 F.R.D. 79 (D. Minn. 1972) 29n

Beard v. Elster, 39 Del. Ch. 153, 165, 160 A.2d 731, 738-39 (1960) 15n

Bernstein v. Mediobanca di Credito, 69 F.R.D. 592, 597 (S.D.N.Y. 1974) 40n

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-41 (1975) 14n

Brody v. Chemical Bank, 482 F.2d 1111, 1114 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973), *on remand*, 66 F.R.D. 87, 89 (S.D.N.Y. 1974), *aff'd*, 517 F.2d 932, 934 (2d Cir. 1975) 29n

PAGE

Brooks v. American Export Indus., Inc., 68 F.R.D. 506, 510 (S.D.N.Y. 1975) 29n

Chelrob v. Barrett, 293 N.Y. 442, 460, 57 N.E.2d 825, 833 (1944) 45

Cleveland Bd. of Education v. La. Fleur, 414 U.S. 632, 644-45 (1974) 34n

Cohen v. Beneficial Loan Corp., 337 U.S. 541, 549 (1949) 12, 12n

Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903) 14, 30, 34n, 40n, 45

Corey v. Independent Ice Co., 207 F. 459, 464 (D. Mass. 1913) 29n

Cort v. Ash, 422 U.S. 66 (1975) 19, 19n, 20, 20n, 22, 48

Cramer v. General Telephone & Electronics Corp., 582 F.2d 259 (3d Cir. 1978) 41, 44

Davis v. Louisville Gas & Electric Co., 16 Del. Ch. 157, 169, 142 A. 654, 659 (1928) 16n

deHaas v. Empire Petroleum Co., 286 F. Supp. 809 (D. Colo. 1968), *aff'd in part and vacated in part*, 435 F.2d 1223, 1228 (10th Cir. 1970) 28n

Detroit v. Dean, 106 U.S. 537 (1882) 14

Dimpfell v. Ohio & Mississippi R. Co., 110 U.S. 209, 210-11 (1884) 13, 14, 30

Findley v. Garrett, 109 Cal.App.2d 166, 174, 240 P.2d 421, 426 (1952) 40n

Fogel v. Chestnutt, 533 F.2d 731, 738 n.7 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976) 37, 40n, 44n, 46, 52

Glassberg v. Boyd, 35 Del. Ch. 293, 308, 116 A.2d 711, 720 (1955) 45

Goodwin v. Castleton, 19 Wash. 2d 748, 764, 144 P.2d 725, 733 (1944) 40n

Hawes v. Oakland, 104 U.S. 450, 461-62 (1881) 13, 14, 18, 30

PAGE

Heit v. *Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977) 28n, 29, 29n, 32, 32n

Independent Investor Protector League v. *Saunders*, 64 F.R.D. 564, 570-71 (E.D. Pa. 1974) 29n

In re Kauffman Mutual Fund Actions, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973) 28n, 29, 29n, 32, 32n, 45, 50, 51

Issner v. *Aldrich*, 254 F. Supp. 696, 699-700 (D. Del. 1966) 45

Ella M. Kelly & Wyndham, Inc. v. *Bell*, 266 A.2d 878 (Del. 1970) 15n

Lasker v. *Burks*, 404 F.Supp. 1172, and January 7, 1977, reported at 426 F. Supp. 844 ....2, 6, 7, 8, 17, 43, 44, 48n

Lasker v. *Burks*, 567 F.2d 1208 (2d Cir. 1978) 2, 10, 18n, 21, 22, 23n, 31n, 35, 37, 40, 44, 48, 48n

Lerman v. *ITB Management Corporation*, 58 F.R.D. 153, 156-59 (D. Mass. 1972) 29n

Liboff v. *Wolfson*, 437 F.2d 121, 122 (5th Cir. 1971) 28n

Lutz v. *Boas*, 39 Del. Ch. 585, 608, 171 A.2d 381, 395 (1961) 12n

McKee v. *Rogers*, 18 Del. Ch. 81, 156 A. 191 (1931) ..14n, 15n

Meyers v. *Keeler*, 414 F. Supp. 935, 938 (W.D. Okla. 1976) 28n, 29n

Moses v. *Burgin*, 445 F.2d 369, 376 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971) 37, 52

Moskowitz v. *Bantrell*, 41 Del. Ch. 177, 190 A.2d 749 (1963) 15n

Pollitz v. *Wabash Railroad Co.*, 207 N.Y. 113, 124, 100 N.E. 721, 724 (1912) 45

Price v. *Gurney*, 324 U.S. 100 (1945) 19, 22

Puma v. *Marriott*, 283 A.2d 693, 696 (Del. Ch. 1971) 15n, 27n, 40n, 45

PAGE

Reserve Management Corp. v. *Anchor Daily Income Fund*, [1978] Fed. Sec. L. Rep. (CCH) ¶96,566 at p. 94374 (S.D.N.Y. 1978) 38n, 49n

Robinson v. *Pittsburgh Oil Ref. Corp.*, 14 Del. Ch. 193, 199, 126 A. 46, 48 (1924) 34n

Ross v. *Bernhard*, 396 U.S. 531, 534 (1970) 14n, 29

St. Louis Union Trust Co. v. *Merrill Lynch Pierce Fenner & Smith*, 562 F.2d 1040, 1052 (8th Cir. 1977), *cert. denied*, 98 S.Ct. 1490 (1978) 21

Santa Fe Industries, Inc. v. *Green*, 430 U.S. 462, 479 (1977) 10, 20, 22, 48-49

SEC v. *Sloan*, 98 S.Ct. 1702, 1711-12 (1978) 50n

Stadin v. *Union Electric Co.*, 309 F.2d 912, 921 (8th Cir. 1962), *cert. denied*, 373 U.S. 915 (1963) 14n

Swanson v. *Traer*, 249 F.2d 854, 859 (7th Cir. 1957) 16n

Tannenbaum v. *Zeller*, 552 F.2d 402, 417 (2d Cir.) *cert. denied*, 434 U.S. 934 (1977) 37, 46, 47, 52

United Copper Securities Co. v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917) 18, 19, 22, 45

United States v. *Topco Associates, Inc.*, 405 U.S. 596, 610 (1972) 18

Untermeyer v. *Fidelity Daily Income Trust*, 79 F.R.D. 36 (D. Mass. 1978), *rev'd*, 580 F.2d 22 (1st Cir. 1978) 32, 32n

Vlandis v. *Kline*, 412 U.S. 441, 446 (1973) 34n

Warshaw v. *Calhoun*, 43 Del. Ch. 148, 158, 221 A.2d 487, 493 (1966) 38n, 48n

Wolf v. *Barkes*, 348 F.2d 994, 997 n.4 (2d Cir. 1965) 51n

Statutes:

Delaware Chancery Court Rule 23.1 .... 14n

PAGE

Delaware General Corporation Law
Section 141(a) ... 3, 13n, 15, 15n, 17
Section 141(b) ... 3, 16, 16n
Section 144(a)(1) ... 3, 16, 16n, 17, 18n, 34n, 37

43 Fed. Reg. 31,945 (July 24, 1978) ... 27n, 39n

Federal Rules of Civil Procedure
Rule 23.1 ... *passim*

Investment Advisers Act
15 U.S.C. § 80b-6 ... 4

Investment Company Act of 1940
15 U.S.C. §§ 80a-13(a)(3) and 80a-35 ... 4
15 U.S.C. § 80a-10 ... 3, 16n
15 U.S.C. §§ 80a-2(a)(3), (19) and 80a-10(a) ... 6, 49
15 U.S.C. §§ 80a-35(a) and (b) ... 3, 49
15 U.S.C. § 80a-1, *et seq.* ... 11, 48
15 U.S.C. § 80a-15(c) ... 16n

N.Y. Bus. Corp. Law § 701 (McKinney's Supp. 1977-78) ... 13

Securities Exchange Act of 1934
Section 10(b) ... 20, 41
Rule 10b-5 ... 20, 41

Other Authorities:

ABA, Corporate Director's Guidebook (rev. ed. Jan. 1978), reprinted in 33 Bus. Law. 1595 (1978) ... 24

ALI-ABA Model Bus. Corp. Act § 84 (rev. ed. 1974) ... 13n

Statement of the Business Roundtable, *The Role and Composition of the Board of Directors, of the Large Publicly Owned Corporation*, 33 Bus. Law. 2083, 2110-11 (1978) ... 36

Cohen, *The Outside Director—Selection, Responsibilities, and Contribution to the Public Corporation*, 34 Wash. & Lee L. Rev. 837 (1977) ... 25-26

PAGE

Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168 (1976) ... 14n, 28n

The Conference Board, *Corporate Directorship Practices: Compensation 1977* at viii (1978) ... 38

Estes, *The Emerging Solution to Corporate Governance*, 55 Harv. Bus. Rev. 20, 21-22 (Nov.-Dec. 1977) 25n

2 W. Fletcher, Cyclopedia of the Law of Private Corporations §§ 505, 528, 535 (1969 ed.) ... 13

E. L. Folk, The Delaware General Corporation Law: A Commentary and Analysis 82 (1972) ... 16

Address by S.E.C. Commissioner Roberta Karmel, American Society of Corporate Secretaries, Jan. 11, 1978 ... 25

Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 Bus. Law. 1799, 1804, 1806 (1976) ... 25, 27n, 36n, 38, 44n

Letter to the Editor, Harold M. Williams, The Wall Street Journal, November 2, 1978, at p. 22, col. 4 ... 39

3B J. Moore, Moore's Federal Practice (2d ed. 1978),

¶ 23.1.15 ... 28n

¶ 23.1.19 at 23.1-81-83 ... 28n, 30n

R. Nader, M. Green & J. Seligman, Constitutionalizing The Corporation: The Case for the Federal Chartering of Giant Corporations (1976) ... 12n

Note, *Demand on Directors and Shareholders as a Prerequisite To A Derivative Suit*, 73 Harv. L.Rev. 746, 759 (1960) ... 28n

2 PH Corporations, Current Statutes 376 (1968) ... 15n

PAGE

D.S. Ruder, Report on Symposium Held at Harvard Business School: The Role and Composition of the Board of Directors of a Large Publicly Held Corporation 7 (May 25, 1977) 38

Schwartz, *A Case For Federal Chartering of Corporations,* 31 Bus. Law. 1125 (1976) 12n

S.Rep. No. 91-184, 91st Cong., 1st Sess. at 33 (1969), *reprinted in* [1970] U.S. Code Cong. & Admin. News 4897, 4903 49

The Wall Street Journal,
March 10, 1978, at 37, col. 1 5
October 25, 1978, at 34, col. 3 5
November 9, 1978, at 7, col. 1 5

7A C. Wright and A. Miller, Federal Practice and Procedure: Civil (1972 ed.),

§ 1831, at 377-78 .... 30n

§ 1832, at 384 .... 28n

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-1724

HARRY G. BURKS, JR., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

BRIEF OF INVESTORS DIVERSIFIED SERVICES, INC., AS *AMICUS CURIAE*

INTEREST OF THE *AMICUS CURIAE*

Investors Diversified Services, Inc. ("IDS"), files this brief as *amicus curiae* with the consent of all parties, urging that the judgment of the Court of Appeals for the Second Circuit be reversed. The decision of the Court of Appeals below is of substantial concern to IDS, the investment adviser to the nation's largest mutual fund complex.[1] The decision held as a matter of law that a quorum of investment company (mutual fund) independent directors may not terminate a shareholder derivative suit, allegedly brought for the fund's benefit, despite such quorum's unanimous determination that prosecuting the action would not be in the fund's best interests. At the very least, this decision places mutual funds in a uniquely disadvantageous position when their independent directors attempt to decide such questions in the best interests of all of their shareholders.

[1] IDS is the investment adviser to ten open-end mutual funds. IDS-associated mutual funds have assets approximating $5 billion, held on behalf of over one million shareholder accounts.

The District Court upheld the power of independent mutual fund directors to act on shareholder derivative claims, but the Court of Appeals elected to reverse on grounds which were, at least in part, significantly different from those advanced by the respondent shareholders. Thus, the impact of the reasoning employed by the court below was largely unanticipated.

In this brief, IDS seeks to bring to the Court's attention the pervasive ramifications of the decision below to the mutual fund industry and to the federal court system, and to emphasize that a resolution of now-conflicting application of rules for corporate governance is of critical importance to the functioning of the entire mutual fund industry, and, indeed, to corporations generally.

OPINIONS BELOW

The opinion of the Court of Appeals, *Lasker* v. *Burks,* is reported at 567 F.2d 1208 (2d Cir. 1978). The opinion appears in the Appendix filed in this Court by Harry G. Burks, Jr., *et al.* ("Petitioners"). (A. 39-48).[2] Also set forth in that Appendix are the opinions of the United States District Court for the Southern District of New York dated October 17, 1975 (as amended), reported at 404 F. Supp. 1172, and January 7, 1977, reported at 426 F. Supp. 844. (A. 5-38).

QUESTIONS PRESENTED

1. Whether the federal policy respecting mutual funds as expressed in the Investment Company Act preempts long-established state corporation law authorizing independent directors to determine whether the maintenance of a shareholder derivative action is in the best interests of the corporation.

[2] "A." references are to the Appendix filed herein pursuant to Rule 36 of this Court.

2. Whether the policies embodied in the business judgment rule and the demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure reflecting a strong policy preference for intracorporate resolution of disputes concerning pursuit of possible corporate claims should be abrogated by a judicially-created irrebuttable presumption, which cannot logically be confined to the mutual fund context, that the independent members of a mutual fund board of directors can never fairly evaluate a possible claim against the other directors.

3. Whether the independent members of the board of directors of a mutual fund, whose presence on such board is specifically mandated by the Investment Company Act so that they may serve as "watchdogs" for the interests of the fund and its shareholders, should be under any special disability in deciding whether or not the fund's best interests are served by pursuing derivative claims brought by a shareholder allegedly for the fund's benefit.

STATUTES AND RULES INVOLVED

The statutes and rules involved in this case are Sections 141(a), 141(b) and 144(a) of the Delaware General Corporation Law, 8 Del. Code §§ 141(a) and (b), 144(a) (1975), Sections 10(a), 36(a) and 36(b) of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-10(a), 80a-35(a) and (b) (1970), and Rule 23.1 of the Federal Rules of Civil Procedure. These statutes and rules are set forth in full in an Addendum at the end of this brief.

STATEMENT OF THE CASE

Fundamental Investors, Inc. ("Fundamental"), was chartered as a corporation by the State of Delaware on October 17, 1932, for the purpose of engaging in the mutual fund business. By 1969, Fundamental had over 90,000

shareholders and a portfolio of approximately $1 billion. Between November 26 and December 8, 1969, it purchased, as a short-term investment, $20 million of 270-day notes issued by the Penn Central Transportation Company ("Penn Central"). Because of Penn Central's bankruptcy in June 1970, the notes were not paid at maturity.

The notes had been sold to Fundamental by Goldman, Sachs & Co. ("Goldman, Sachs"), a leading commercial paper dealer. On November 4, 1970, Fundamental and others brought suit against Goldman, Sachs, claiming that it had violated various antifraud provisions of the federal securities laws and seeking rescission of the Penn Central note transactions.

In early February 1973, more than three years after Fundamental had purchased the Penn Central notes, two of Fundamental's more than 90,000 shareholders (hereinafter "plaintiffs") commenced the instant derivative action, allegedly on behalf, and for the benefit, of Fundamental. No demand was made upon the directors before the complaint was filed. Named as defendants were Fundamental, its investment adviser Anchor Corporation ("Anchor"), and all of Fundamental's ten directors serving in 1969 when the notes were purchased.[3]

The complaint sought damages for the defendants' alleged violations of Sections 13(a)(3) and 36 of the Investment Company Act of 1940 [15 U.S.C. §§ 80a-13(a)(3) and 80a-35], and Section 206 of the Investment Advisers Act (15 U.S.C. § 80b-6). It also alleged that certain defendants breached common law fiduciary duties and the investment advisory contract. The principal thrust of the factual allegations was that the investment adviser made an insufficient examination of Penn Central's financial condition

[3] The directors were: Harry G. Burks, Jr., Edward B. Burr, Thomas F. Chalker, John R. Haire, Harvey E. Hopkins, S. P. Hutchison, Donald L. Kemmerer, A. S. Mike Monroney, Charles F. Phillips, and Jeptha H. Wade.

prior to purchase of the notes. Further proceedings in the derivative action were stayed by the District Court pending resolution of Fundamental's lawsuit against Goldman, Sachs.

On July 9, 1974, after completion of discovery and one day before the scheduled commencement of trial, Fundamental settled its claims against Goldman, Sachs. Goldman, Sachs took back the Penn Central notes, paid Fundamental $5.25 million in cash, and assigned to Fundamental a 73.75% interest in the proceeds of the notes in the Penn Central reorganization proceedings.[4]

At its next regular meeting after settlement with Goldman, Sachs, held on July 24, 1974, Fundamental's board reviewed the status of plaintiffs' suit. The board decided that the five directors who were not named as defendants would act as a quorum of the board, pursuant to Section 141 of the Delaware General Corporation Law and Fundamental's By-laws, to determine what position Fundamental should take regarding this action.[5] The remaining directors

[4] On March 9, 1978, the United States District Court for the Eastern District of Pennsylvania preliminarily approved a Penn Central plan of reorganization, *see The Wall Street Journal*, March 10, 1978, at 37, col. 1; *id.*, October 25, 1978, at 34, col. 3. As part of the plan, holders of Penn Central notes will receive, in exchange for their notes and accrued interest thereon to December 31, 1977, shares of common stock of the reorganized company and certificates of beneficial interest in certain proceeds of the sale of certain assets of Penn Central. Fundamental's interest in the Penn Central notes arising from the settlement with Goldman, Sachs should entitle it, we estimate, to approximately 192,000 shares of common stock and certificates of beneficial interest with a face value of approximately $6.6 million. The common stock is presently trading publicly at a price of approximately $16 per share. Thus, Fundamental's settlement with Goldman, Sachs will result in recovery of at least an additional $3 million, without regard to the market value of the certificates of beneficial interest, in which trading has not yet begun. See *id.*, November 9, 1978, at 7, col. 1.

[5] Five of Fundamental's directors assumed office after the purchases of the Penn Central notes and were thus not named as defendants.

agreed to take no part whatsoever in the independent directors' determination. (A. 67-70).

These five directors (hereinafter the "independent quorum"), statutorily disinterested persons under the Investment Company Act [15 U.S.C. §§ 80a-2(a)(19) and 80a-10(a)], were: Louis F. Laun, elected in 1971; Mary S. O'Connor, elected in 1972; Dr. Beryl Robichaud and William J. Stephens, elected in 1973; and Leon T. Kendall, elected in 1974.

The independent quorum retained special counsel, Hon. Stanley H. Fuld, former Chief Judge of the State of New York, to advise them concerning Fundamental's possible claims against its investment adviser and the other defendants. Special counsel had no previous connection with any of the parties.[6] Judge Fuld studied plaintiffs' complaint, the proceedings in the action against Goldman, Sachs, and the files of Fundamental and its investment adviser relating to the Penn Central note transactions; he interviewed officers and employees of Fundamental and the adviser; and he analyzed the facts and the law. On December 5, 1974, special counsel reported to the independent quorum in a comprehensive 40-page legal and factual memorandum, concluding that there was no violation by the defendants herein of any statutory, common law or contractual duty to Fundamental.

The directors constituting the independent quorum met, reviewed the subjects raised by special counsel's memorandum, discussed the various alternatives open to Fundamental, and posed additional questions to special counsel, who sent them a supplemental memorandum on December 18, 1974. That memorandum pointed out that the question

[6] In the District Court, plaintiffs claimed that the Secretary of Fundamental, acting under the direction of defendant Haire, retained special counsel. Judge Werker rejected this contention, finding that Judge Fuld was retained by the independent quorum of directors. 426 F. Supp. at 850. The Court of Appeals did not disturb this finding.

of whether plaintiffs' claims were to be enforced in the courts was, like other matters concerning the corporation's best interests, properly committed to the discretionary business judgment of the independent quorum.

The independent quorum next held a series of discussions and special meetings to consider special counsel's memoranda. On January 6, 1975, they unanimously determined that prosecution of plaintiffs' suit was contrary to the best interests of Fundamental and its shareholders (other than the two plaintiffs). The factors relied upon by the independent quorum included the dim prospects of recovering from any defendant amounts beyond those already paid by Goldman, Sachs; special counsel's opinion that there was no real merit to the claims and little likelihood of success; the substantial litigation expense to Fundamental; and the major disruption of Fundamental's affairs which would accompany litigation, including the probability that Fundamental would have to replace its investment adviser. *See* 404 F. Supp. at 1176-77 (S.D.N.Y. 1975) (Werker, J.).

On instructions from the independent quorum, litigation counsel for Fundamental thereafter moved to dismiss plaintiffs' action as not being in the best interests of the corporation. The District Court held that the independent quorum of Fundamental's board had complete power under the business judgment rule to bar prosecution of this action if the directors who made the decision were truly disinterested and independent. *Id.* at 1180.

Plaintiffs raised a factual issue of whether the quorum was disinterested and independent, and the District Court accordingly held further proceedings related solely to that issue. Depositions of the members of the independent quorum revealed that none of them is related to any defendant by blood or marriage, that none is or ever was a business partner of any of the defendants, that none has or had any business or professional relationships with or interest in the investment adviser, and that none had any

close personal friendship with any of the defendants, though four were acquainted with one or more of the defendants at the time they were nominated to the board. (R. 209A-213A; R. 479A-480A; R. 529A-534A; R. 649A-655A; R. 671A-674A; R. 690A; R. 812A; R. 916A-917A; R. 919A-920A; R. 937A; R. 989A-990A).[7] Two of the five members of the quorum—Laun and O'Connor—were elected to Fundamental's board well before the *Lasker* action was commenced in February 1973. (R. 173A-179A). Further, no defendant mentioned the *Lasker* action to any of these five directors before, at the time of, or in connection with, their nominations to the board of directors. (R. 527A-529A; R. 686A-688A; R. 704A; R. 784A-786A; R. 854A-855A; R. 943A-948A; R. 990A). Finally, these directors testified that the merits of the *Lasker* action were not considered by the board until its July 24, 1974 meeting following settlement of the action against Goldman, Sachs. (R. 252A-253A; R. 657A-658A; R. 687A-688A; R. 785A-787A; R. 851A-852A; R. 949A-959A).

Accordingly, after exhaustive discovery and argument on the question of the quorum's activities and independence, the District Court granted Fundamental's motion to dismiss on January 7, 1977, finding that plaintiffs "have not adduced any factual support for their conclusion that the members of the disinterested quorum acted other than independently." 426 F. Supp. 844, 849 (S.D.N.Y. 1977).

Plaintiffs appealed the dismissal of their complaint to the Court of Appeals for the Second Circuit. On January 11, 1978, that court reversed, holding that the independent directors lacked power to terminate plaintiffs' derivative action. A petition for rehearing *en banc* was denied on March 9, 1978. Defendants timely filed a petition for a writ of certiorari with this Court on June 2, 1978, and the petition was granted on October 2, 1978.

---

[7] "R." references are to the three-volume printed Appendix filed in the Court of Appeals for the Second Circuit. The page numbers refer to the consecutive numbers stamped on the pages of that printed Appendix.

SUMMARY OF ARGUMENT

The decision of the Court of Appeals for the Second Circuit in this case incorrectly disregarded controlling principles of Delaware corporate law governing the powers of corporate directors. The court below held that an independent quorum of mutual fund directors found by the District Court to be "truly independent" was disqualified, as a matter of law, from deciding to terminate a shareholder derivative suit, allegedly brought for the corporation's benefit, which it had determined was not in the best interests of the corporation, despite the fact that the independent directors who comprised the quorum made such determination in "good faith" after extensive consultation with independent special counsel.

The business judgment rule is a well-settled principle of Delaware law—and of state law generally—which places the responsibility for the management of a corporation, including decisions as to whether or not to pursue a possible corporate claim through litigation, in the hands of independent directors duly elected by the corporation's shareholders. The District Court honored this principle, but the Court of Appeals regarded it as irrelevant. The result reached below, if applied generally, threatens the basic structure of intracorporate governance by permitting two shareholders among 90,000 to impose their will upon the corporation by continuing to maintain this litigation, ostensibly on behalf of the corporation, in spite of the informed opposition of the independent quorum which was duly charged under Delaware law with the responsibility to assess the proposed claims.

Although the Court of Appeals purported to find support for this extraordinary result in the fact that respondents were presenting claims involving federal policies, such a basis for ignoring state corporate governance law is clearly inconsistent with a long line of decisions of this Court.

The most recent such decision, *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 479 (1977), holds that such state law will be displaced only when federal law "expressly" requires it—a test not satisfied here.

The Court of Appeals also buttressed its decision to ignore settled state law by creating an irrebuttable presumption of law that the independent members of a board of directors are incapable of passing fairly upon proposed corporate claims directed in part at their fellow directors, 567 F.2d at 1212, and by referring to "the unique nature of the investment company and its symbiotic relationship with its investment adviser." *Id.* at 1212 n.14. Neither of these rationales withstands analysis.

The creation of this presumption is especially unwise when our legal system is placing increasing reliance upon the addition of significant numbers of independent directors—such as those who acted in this case—to corporate boards. These directors should be given the chance to serve their monitoring function, not stripped of that opportunity on the basis of an irrebuttable presumption that may frustrate this desirable trend.

Further, the presumption employed by the Court of Appeals to ignore the independent directors' decision cannot logically be confined to corporations which happen to be mutual funds or to cases in which the deciding directors constitute a significant percentage of the board, albeit a minority. Thus, unless reversed, the decision below has the potential to expand greatly shareholder derivative litigation (involving both mutual funds and other public corporations) in the federal courts by undermining both the business judgment rule and the requirement of Rule 23.1 of the Federal Rules of Civil Procedure of a demand on directors prior to the commencement of derivative litigation. Since shareholder plaintiffs will, on this analysis, now be able to maintain derivative suits in spite of the contrary judgment of an independent quorum of

the board, the decision below reverses the traditional preference of both the business judgment rule and Rule 23.1 for intracorporate (rather than judicial) determination of whether or not to sue on proposed corporate claims.

The Court of Appeals' decision is especially unwarranted since the subjective factors relied upon below in creating this new rule of presumptive disqualification provide neither factual nor logical support for such a result. Even that court's effort to limit the reach of its presumption conflicts with the basic policy underlying the business judgment rule. In sharp contrast, the District Court's careful evaluation of the evidence relating to the independence and good faith of the deciding directors was not only consistent with the decided cases, but also assured that no unfairness in fact resulted from giving effect to the independent quorum's decision to terminate this suit.

Finally, to the extent that the Court of Appeals sought support for its decision in the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*, it drew from the legislative materials precisely the opposite conclusion from that intended by Congress, which has attempted to enhance and strengthen the role of mutual fund independent directors as "watchdogs" for the interests of all shareholders. The decision below conflicts not only with Congressional intent, but also with a leading decision of the Court of Appeals for the First Circuit which properly interpreted the Investment Company Act to uphold the right and duty of mutual fund independent directors to determine whether the pursuit of shareholder derivative claims is in the best interests of the fund. Moreover, the decision below conflicts with previous decisions of the Court of Appeals for the Second Circuit that reached results analogous to that in the First Circuit. If allowed to stand, the decision below significantly limits the opportunity of such directors to exercise their responsibility in an important area of mutual fund management.

ARGUMENT

I.

The Decision of the Court of Appeals Improperly Preempts Basic State Law Principles Concerning the Management of Corporate Affairs

Simply stated, the issue presented here is whether the independent quorum of directors, acting on behalf of Fundamental and all of its shareholders, had the power to decide that the derivative claims proposed by two of the fund's 90,000 shareholders should not be pursued. The District Court, relying on basic principles of state corporate law, held that such power existed and dismissed plaintiffs' derivative suit. The Court of Appeals, however, reached the opposite conclusion. Its decision, we submit, has seriously undermined the primacy which has long been accorded to state law as the source of the legal rules applicable to the governance of corporations.

Business corporations—including mutual funds—are creatures of state, not federal, law. *Cohen* v. *Beneficial Loan Corp.*, 337 U.S. 541, 549 (1949).[8] While state statutes

---

[8] As this Court stated in *Cohen, supra:* "Whatever theory one may hold as to the nature of the corporate entity, it remains a wholly artificial creation whose internal relations between management and stockholders are dependent upon state law. . . ." *Id.* at 549. Mutual funds, though regulated under federal law, are still creatures of the states of their incorporation. *See* Lutz v. Boas, 39 Del. Ch. 585, 608, 171 A.2d 381, 395 (1961). While some commentators have suggested that this pattern be changed so that the federal government assumes the role of chartering corporations, *see, e.g.*, R. Nader, M. Green & J. Seligman, Constitutionalizing The Corporation: The Case for the Federal Chartering of Giant Corporations (1976) and Schwartz, *A Case For Federal Chartering of Corporations*, 31 Bus. Law. 1125 (1976), Congress has yet to enact such legislation.

vary somewhat with respect to the conduct of corporate affairs, directors are generally charged with the responsibility of managing or directing the management of business corporations.[9] This principle is fundamentally democratic: since directors are elected by vote of all of the shareholders for the very purpose of deciding where the corporation's best interests lie, the exercise of their business judgment concerning management of corporate affairs ordinarily binds all of the shareholders, even those who disagree with a particular directorial decision. Although each shareholder can refuse to vote for board members when they next stand for reelection if dissatisfied with the way they exercise their business judgment, the directors' judgment generally may not be questioned in the courts at the behest of a single shareholder. *Hawes* v. *Oakland*, 104 U.S. 450, 460-61 (1881); *Dimpfell* v. *Ohio & Mississippi R. Co.*, 110 U.S. 209, 210-11 (1884); 2 W. Fletcher, Cyclopedia of the Law of Private Corporations §§ 505, 528, 535 (1969 ed.).

This basic set of axioms reflects a legal and policy preference for the resolution of disputes concerning the management of corporations within the corporate structure, rather than in the courts. For the better part of a century, this Court has contributed significantly to the development and implementation of these principles, initially by setting forth the general rules reserving corporate management to duly elected, independent directors and carefully explaining the rationale upon which those rules are based, and more recently by rejecting suggestions advanced by dissentient shareholders that established state law concerning corporate governance should be subverted or ignored because of asserted conflicts with federal policies of one kind or another.

---

[9] *See, e.g.*, Delaware Code, Title 8, § 141(a) (1975); N.Y. Bus. Corp. Law § 701 (McKinney's Supp. 1977-78); ALI-ABA Model Bus. Corp. Act § 35 (rev. ed. 1974).

The business judgment rule evolved in this Court through a series of decisions stressing the directors' control over corporate assets, including the disposition of possible corporate claims. *See, e.g., Hawes, supra; Dimpfell, supra; Detroit* v. *Dean,* 106 U.S. 537 (1882).[10] In *Corbus* v. *Alaska Treadwell Gold Mining Co.,* 187 U.S. 455, 463 (1903), this Court stated:

> "The directors represent all the stockholders and are presumed to act honestly and according to their best judgment for the interests of all. Their judgment as to any matter lawfully confided to their discretion may not lightly be challenged by any stockholder or at his instance submitted for review to a court of equity. The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors or the corporation to enforce every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an act which their judgment does not approve, or to substitute his judgment for theirs."

[10] From the same cases, there emerged a procedural framework serving the same ends as the underlying substantive legal principles. *See* Ross v. Bernhard, 396 U.S. 531, 534 (1970). Because derivative suits may be inconsistent with the best interests of all shareholders and may in fact be abused, *see* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-41 (1975), several significant procedural limitations have been imposed on derivative plaintiffs. One of the most important is the requirement that a dissentient shareholder exhaust intracorporate remedies. Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions,* 44 U. Chi. L. Rev. 168 (1976). The exhaustion requirement —which is a common feature of both the Federal Rules of Civil Procedure and of state practice—is implemented by imposing a duty upon a putative derivative plaintiff to make a demand on the directors to sue on his proposed claim, or to demonstrate specifically why such a demand would be futile. *See, e.g.,* Rule 23.1 of the Federal Rules of Civil Procedure; Delaware Chancery Court Rule 23.1.

If after such demand the directors conclude not to sue, their decision will be tested under the business judgment rule and will be final unless the shareholder can demonstrate that such decision was itself somehow tainted. As stated in *Stadin* v. *Union Electric Co.,* 309 F.2d 912, 921 (8th Cir. 1962) (Blackmun, C.J.), *cert. denied,* 373 U.S. 915 (1963): "'[T]he sine qua non of the stockholder's derivative right to sue' [after satisfying the demand requirement], is that management be guilty of conduct equivalent to bad faith or breach of trust." *See also* Comment, 44 U. Chi. L. Rev., *supra,* at 193-98; Detroit v. Dean, *supra*; McKee v. Rogers, 18 Del. Ch. 81, 156 A. 191 (1921). The likely impact of the Court of Appeals' decision in the instant case upon the exhaustion requirement is discussed in Point II, *infra.*

Fundamental—the corporation whose interests are the only ones at issue in this case—is a Delaware corporation, deriving such powers as it possesses under its Certificate of Incorporation and By-laws directly from Delaware law. Section 141(a) of the Delaware General Corporation Law provides in part that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors. . . ."[11] The Delaware courts have repeatedly held that a good faith exercise of business judgment by a corporation's board of directors—including a decision whether or not to sue on a possible corporate claim—may not be overturned by a shareholder through the mechanism of a derivative suit.[12]

[11] Delaware Code, Title 8, § 141(a) (1975). The phrase "or under the direction of" was added to Section 141(a) in 1974, 59 Del. Laws, Ch. 437, § 25, for the sake of clarity and to make explicit results previously reached in the Delaware case law. 2 PH Corporations, Current Statutes 376 (1974).

[12] *See, e.g.,* McKee v. Rogers, *supra;* Ella M. Kelly & Wyndham, Inc. v. Bell, 266 A.2d 878 (Del. 1970); Moskowitz v. Bantrell, 41 Del. Ch. 177, 190 A.2d 749 (1963); Beard v. Elster, 39 Del. Ch. 153, 165, 160 A.2d 731, 738-39 (1960); Puma v. Marriott, 283 A.2d 693, 696 (Del. Ch. 1971). *See also* Davis v. Louisville Gas

Delaware law also provides flexible mechanisms that permit a board of directors to perform its functions when some directors are absent or may be disqualified by self-interest from exercising independent business judgment. Section 141(b) of the General Corporation Law provides for corporate decisions by majority vote of a quorum which may consist of less than a numerical majority of the whole board.[13] Indeed, under Section 144(a)(1), first enacted in 1967 and as amended in 1969, a majority of the independent directors of a Delaware corporation, whether or not they constitute a quorum, is specifically empowered to approve "transactions" between that corporation and its own directors or other corporations in which such directors have an interest.[14] Professor Folk, who served as the Reporter for the Delaware Corporation Law Revision Committee during 1964 through 1967, has stated that "transactions affected by § 144" should be broadly interpreted and should include, *inter alia,* "determinations with respect to maintaining suits by the corporation against persons allegedly injuring it. . . ." E.L. Folk, The Delaware General Corporation Law: A Commentary and Analysis 82 (1972).

& Electric Co., 16 Del. Ch. 157, 169, 142 A. 654, 659 (1928). This rule is one of general application under the law of most if not all jurisdictions. *See* Swanson v. Traer, 249 F.2d 854, 859 (7th Cir. 1957).

[13] Delaware Code, Title 8, § 141(b) (1975).

[14] The present version of Section 144 is set forth in the Addendum to this brief. The Section was originally enacted in 1967. 56 Del. Laws, Ch. 50. In 1968, the Delaware legislature made technical amendments to the Section, *see* 56 Del. Laws, Ch. 186, § 5, and in 1969, the Section was amended to its present form. 57 Del. Laws, Ch. 148.

Section 144(a)(1) is consistent with analogous principles of the Investment Company Act of 1940. *See, e.g.,* Sections 15(c) and 10(a) of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-15(c) and 80a-10(a) (1970), which provide that adoption and renewal of the investment adviser's contract require a majority vote of the disinterested directors and that only 40% of the fund's directors need be disinterested.

In the present case, Fundamental's Certificate of Incorporation and By-laws provided, as was permissible under Section 141(a), that a quorum of one-third of the directors could transact business on behalf of the corporation. 404 F. Supp. at 1172, 1175 n.1. Thus, when the full board delegated to the independent quorum the question of whether pursuit of plaintiffs' proposed suit was in the best interests of Fundamental, under Section 141(a) that quorum became Fundamental's board with respect to deciding that question. Moreover, the delegation itself was a course of action expressly sanctioned by Section 144(a)(1). The subsequent decision of the independent quorum to seek dismissal was entitled to the deference normally accorded directors' decisions under the business judgment rule evolved at common law in Delaware and elsewhere.

This established state law framework, designed to promote informed decision-making within the corporate structure itself, was ignored by the decision of the court below, which permits two shareholders to substitute their judgment for that of the lawful quorum of Fundamental's directors determined by the District Court to be "truly disinterested and independent." 426 F. Supp. at 847. The Court of Appeals' decision requires a trial on the merits herein notwithstanding the independent directors' informed, good faith judgment that continuing with the case is not in the corporation's best interests.

The Court of Appeals erroneously believed that it was empowered to disregard state corporate governance law because the plaintiffs' claims were, at least in part, based on alleged violations of federal policies as set forth in the Investment Company Act. This holding disregards a long and remarkably uniform series of decisions by this Court that shareholders cannot wrest from the directors their authority, via the exercise of informed and independent business judgment, over potential corporate claims merely

because prosecution of those claims might arguably further certain federal interests.[15]

There are, of course, certain areas of substantive law where under the Supremacy Clause federal law preempts state law. The Court of Appeals evidently presumed that it was empowered to disregard state corporate law because a federal policy in favor of protecting mutual fund investors permitted such a result. However, the decision below sweeps far too broadly in simply ignoring the basic substantive state law governing the internal operations of corporations. We know of no decision that has reached a comparable result, no matter how "strong" a federal policy was involved.

The federal policy underlying the antitrust laws is so strong that the Sherman Act has been characterized as "the Magna Carta of free enterprise." *United States* v. *Topco Associates, Inc.*, 405 U.S. 596, 610 (1972). Yet even this fundamental federal policy does not displace the business judgment rule when a shareholder seeks to assert derivatively a corporate antitrust claim over directorial opposition. In *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917), this Court, relying on *Hawes, supra,* and its progeny, flatly rejected a shareholder's attempt to bring a treble damage action on behalf of a corporation after its directors had declined to file such a suit. In response to the same argument advanced by plaintiffs below—that federal policy would be thwarted unless the directors' business judgment was overridden—Justice Brandeis held:

> "The fact that the cause of action is based on the Sherman Law does not limit the discretion of the

[15] The Court of Appeals did acknowledge that, under Delaware law, the five independent directors constituted a lawful quorum of Fundamental's board, but it ignored both Section 144 and the controlling body of common law in passing upon the business judgment issue which was presented. *See* 567 F.2d at 1210 n.5.

> directors or the power of the body of stockholders; nor does it give to individual shareholders the right to interfere with the internal management of the corporation." 244 U.S. at 264.

In *Price* v. *Gurney*, 324 U.S. 100 (1945), corporate security holders filed a derivative bankruptcy petition alleging, as do the plaintiffs, that the directors of their company were guilty of a breach of trust and that the pervasive policy embodied in a federal statute (the Bankruptcy Act) permitted them to override the business judgment of the board of directors and invoke the jurisdiction of the bankruptcy court for the corporation's benefit without directorial consent. This argument was quickly rejected:

> "[N]owhere is there any indication that Congress bestowed on the bankruptcy court jurisdiction to determine that those who in fact do not have the authority to speak for the corporation as a matter of local law are entitled to be given such authority and therefore should be empowered to file a petition on behalf of the corporation. Respondents may have a meritorious case for relief. On that we intimate no opinion. But if they are to be allowed to put their corporation into bankruptcy, they must present credentials to the bankruptcy court showing their authority." 324 U.S. at 107.

The principle set forth in *United Copper* and *Price* has been consistently followed by this Court, albeit in somewhat different contexts. *See Cort* v. *Ash,* 422 U.S. 66 (1975).[16] Indeed, even in the area of federal regulation

[16] In *Cort*, this Court was faced with a shareholder derivative claim for damages based upon as intrinsic a federal concern as the integrity of federal elections under the Federal Election Campaign Act. There, as here, the shareholder, complaining of supposed federal statutory violations, asserted the right to maintain his damage action to recover allegedly unlawful campaign

of transactions in securities this Court has refused to allow interference with state laws of corporate governance. In *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462 (1977), this Court refused to allow a shareholder to maintain a derivative action raising federal securities antifraud claims under the Securities Exchange Act of 1934 (analogous to those raised by plaintiffs here) on behalf of a corporation involved in a Delaware statutory short-form merger. Reiterating its earlier holding in *Cort* v. *Ash, supra,* this Court held in *Santa Fe* that the transaction at issue did not give rise to a cause of action under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, in part because to do so would "overlap and quite possibly interfere with state corporate law." 430 U.S. at 479. Noting that the several states had adopted differing statutory standards governing short-form mergers, *id.* at n.16, this Court stated:

> "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." *Id.*

---

contributions for the corporation's benefit. Mr. Justice Brennan, writing for a unanimous court, refused to imply a federal cause of action under that statute, stating that "[A private cause of action by a stockholder to secure derivative damage relief] is available, if at all, under Delaware law governing corporations." 422 U.S. at 77-78 (footnote omitted). This decision was based, in part, on the ground that:

> "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation. . . . We are necessarily reluctant to imply a federal right to recover funds used in violation of a federal statute where the laws governing the corporation may put a shareholder on notice that there may be no such recovery." *Id.* at 84-85.

See also St. Louis Union Trust Co. v. *Merrill Lynch, Pierce, Fenner & Smith,* 562 F.2d 1040, 1052 (8th Cir. 1977), *cert. denied,* 98 S.Ct. 1490 (1978) (rejecting an attempt to read a requirement into Rule 10b-5 that would have the effect of overriding provisions of the Delaware General Corporation Law governing stock transfer restrictions).

This Court has thus consistently deferred to state law relating to the management of business corporations, including the elemental principle of state law that independent and disinterested corporate directors have the responsibility and obligation to determine the course of action which is in the corporation's best interests. The business judgment rule and the Delaware statutes providing for management of Fundamental by a disinterested quorum of directors defeat attempts by shareholders to sue over the directors' objection, even though the proposed derivative claim is grounded in part on a federal statute.

The court below nevertheless concluded that "the plethora of cases . . . dealing with the powers of boards of directors to terminate stockholder derivative suits and the effect of the demand requirement under Fed. R. Civ. P. 23.1 are inapposite." 567 F.2d at 1212 n.14. It offered two reasons for its decision to disregard these authorities. The first was an irrebuttable legal presumption, based largely upon subjective psychological factors, that the independent directors were here disqualified from exercising their business judgment because they could not pass fairly on a claim directed in part at some of their fellow directors. Since the independent directors "must constantly deal with interested directors in a spirit of accommodation," since they must "rely on the information and expert advice provided by the adviser and the majority directors," and since their continued service and receipt of directors' fees depend "almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection," the court below stated that:

> "[i]t is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned." *Id.* at 1212.

The second reason offered was "the unique nature of the investment company and its symbiotic relationship with its investment adviser," *id.* at 1212 n.14, which the Court of Appeals discerned from a selection of previous mutual fund decisions and the federal statutory framework regulating certain mutual fund activities.

Neither reason provides sufficient basis for a decision incompatible with this Court's prior decisions in *United Copper, Price, Cort,* and *Santa Fe,* which require compliance with state law concerning corporate governance, and, as we show below, neither reason is persuasive as a matter of law, policy, or logic.

II.

The Decision of the Court of Appeals That the Independent Quorum Was Presumptively Disqualified From Exercising Its Business Judgment Threatens To Expand Greatly Shareholder Derivative Litigation in the Federal Courts

The irrebuttable legal presumption created by the Court of Appeals to support its conclusion that the independent quorum herein lacked the power to decide to seek dismissal of plaintiffs' derivative suit was one of two bases upon which that court concluded that previous decisions upholding the authority of independent directors to control corporate litigation were "inapposite" to decision of this case.[17]

That presumption has consequences extending beyond this case, and it should be rejected by this Court. In this portion of our brief, we show that: (A) the Court of Appeals' presumption is precisely contrary to the central premise underlying the recent tendency of our legal system to place significant numbers of "outside" or independent directors on the boards of all types of corporations, a trend which has employed the mutual fund industry as a model; (B) the presumption improperly reverses the traditional preference, reflected in both the business judgment rule and Rule 23.1 of the Federal Rules of Civil Procedure, for resolution of disputes concerning corporate management within the structure of the corporation rather than in the

[17] There is no doubt that the Court of Appeals held, as a matter of law, that the independent quorum was without power to act. Although the court below set out several bases for its presumption as to "human nature," it clearly did not believe that an independent quorum of board members—even one constituting over 40% of the full board—could ever pass fairly upon proposed corporate claims directed in part at fellow directors. The Court of Appeals expressly stated that it was "unnecessary to consider the findings of the district court that the disinterested directors were sufficiently independent," and that it had no doubt that "the five minority directors acted in good faith in all that they did." 567 F.2d at 1212.

courts; (C) the factors relied upon by the Court of Appeals in support of its presumption do not, in fact, dictate such a result; and (D) the Court of Appeals' "frivolous case" exception to its presumption will also lead to increased derivative litigation, a result which is unnecessary since the District Court's approach herein is not only consistent with the purpose of both the business judgment rule and Rule 23.1, but also avoids any unfairness to shareholders.

Thus, unless this Court acts to remove the impediment which the Court of Appeals created to the ability of an independent quorum to make good faith, informed decisions that bind dissentient shareholders, the effect will be to expand shareholder derivative litigation involving mutual funds and, perhaps, all business corporations.

A. The Court of Appeals' Presumption Is Inconsistent With the Recent Trend To Add Significant Numbers of Outside Directors to Corporate Boards and To Rely More Heavily on Them

In the recent past, a great deal of attention has been focused on the performance of corporate boards of directors. One suggestion that has emerged from this debate has been the notion, referred to above, that the federal government should take over the states' function of chartering major corporations. Another, more measured response has been an increasing emphasis upon more carefully defining the proper function of the board of directors and, at the same time, strengthening the capabilities of directors to perform that function. *See* ABA, Corporate Director's Guidebook (rev. ed. Jan. 1978), reprinted in 33 Bus. Law. 1595 (1978).

Coincident with this effort, numerous commentators who have studied corporate governance have recommended that corporations add outside directors to their boards, and that the operational structure of boards be modified so that all of the directors can better assist in sound management of the firms whose shareholders they serve. This

has been more than an academic exercise, for many American corporations have responded by placing significant numbers of independent directors—*i.e.,* directors who are not corporate officers or employees—on their boards.[18] As this has occurred, students of corporate governance have identified the "monitoring function of outside directors" as "the central role of the board of the future" and have pointed out that a model for a board with substantial numbers of independent directors performing such a function already exists in the mutual fund industry. Leech & Mundheim, *The Outside Director of the Publicly Held Corporation,* 31 Bus. Law. 1799, 1804, 1806 (1976). *See also* Address by S.E.C. Commissioner Roberta Karmel, American Society of Corporate Secretaries, Jan. 11, 1978.

Indeed, this trend is regarded as so significant that, in a number of non-mutual fund contexts, independent directors have been required to be added to corporate boards to perform a "watchdog" role. For example, the New York Stock Exchange recently issued a requirement that each company listed on the exchange have an Audit Committee composed of outside directors, *see* Cohen, *The Outside Director—Selection, Responsibilities, and Contribution to the Public*

---

[18] This trend has been summarized as follows:

"The Conference Board's Jeremy Bacon confirms that his research over the years has shown a steady increase in the number of manufacturing companies having a majority of outside directors [—those who are not salaried employees of the corporation and who are not involved in day-to-day staff or operating decisions—] on their boards. In 1967 this figure was 63% of the companies studied; in 1973, 71%. The 1976 figure reflects that 83% of the nearly 300 companies studied had an outside majority.

"A separate analysis of 175 leading corporations (made by my own office) showed 86% with a majority of outsiders, 10% with a minority, and the 4% balance having equal representation of outsiders and insiders. Both my study and that of the Conference Board confirm that the number of outside directors tends to rise with the size of the company, its complexity, and the extent of its international involvements." Estes, *The Emerging Solution to Corporate Governance,* 55 Harv. Bus. Rev. 20, 21-22 (Nov.-Dec. 1977).

Corporation, 34 Wash. & Lee L. Rev. 837 (1977), and the Securities and Exchange Commission has often required the addition of independent directors when entering into consent decrees with corporations that have been the targets of S.E.C. enforcement actions. *Id.* at 847 and n. 25.

The Court of Appeals, by relying upon vague notions of "human nature" presumptively to disqualify the independent quorum from exercising its business judgment in this case, has intruded upon these developments. By holding that, as a matter of law, the independent quorum lacked the power to make an admittedly difficult decision, the court below in effect entered a sweeping condemnation of the trend described above. Although its action in this regard was probably unintentional, the court's timing could not have been more unfortunate.

It is, in our view, wrong to substitute such a presumption for the careful factual analysis of the quorum's independence and good faith here conducted by the District Court. But beyond that error, the Court of Appeals' approach amounts to a legislative conclusion that the addition of independent directors to mutual fund boards, and by logical extension to corporate boards generally, is merely a symbolic gesture since, "human nature" being what it is, such directors will never be able to divorce their judgment from that of management on matters confided to their discretion. If Congress or the state legislatures are to reach such a judgment in the future, they will presumably do so after examining in detail the performance over time of the independent directors who are only now beginning to serve in significant numbers on corporate boards. Yet the court below has prejudged that issue, ignoring detailed factual findings on the precise question of independence and accepting that the quorum here acted in good faith.

Thus, unless reversed the decision below threatens to stifle the many forces—legal, political and social—which

are combining to change substantially the structure, function, and composition of corporate boards so as to increase the responsibilities and abilities of independent directors to perform a monitoring function.[19] To the extent that this occurs, the courts will inevitably be burdened with more derivative litigation. The results will be both direct, since under the Court of Appeals' reasoning the independent directors had no authority to resolve within the corporation's structure an issue like that presented here, and indirect, since the court's conclusion may actually retard the realization in practice of a model board structure which depends upon service by a significant percentage of independent directors.

B. The Court of Appeals' Presumption Improperly Permits Putative Shareholder Derivative Plaintiffs To Avoid Intracorporate Resolution of Disputes

As we have shown, the business judgment rule rests on a clear policy preference for intracorporate decision-making by the directors charged by state law with managing the affairs of the company. Rule 23.1 of the Federal Rules of

[19] Much of the current literature discussing changes in the structure and functions of corporate boards is summarized in Leech & Mundheim, *supra*, and in an introduction to rules which the S.E.C. has recently proposed which would require corporations to disclose more information about the affiliations of board members with the corporation and with management. *See* 43 Fed. Reg. 31,945 (July 24, 1978). Leech and Mundheim point out that the "monitoring role for independent, outside directors of business corporations, modeled on mutual fund requirements, would in fact be beneficial not only to the shareholders of the corporation, but to management as well." Leech & Mundheim, *supra*, 31 Bus. Law. at 1805. In support of this observation, they cite the District Court's decision in the instant case and *Puma* v. *Marriott*, *supra*, a Delaware case in which the court refused to reexamine a transaction involving possible conflict between the corporation and insiders, stating that "[s]ince the transaction . . . was accomplished as a result of the exercise of independent business judgment of the outside, independent directors whose sole interest was the furtherance of the corporate enterprise, the court is precluded from substituting its uninformed opinion for that of the experienced, independent board members. . . ." 283 A.2d at 696.

Civil Procedure[20] is based on the same rationale.[21] When strictly enforced by the courts, that Rule—which requires a putative derivative plaintiff to provide particularized allegations of the efforts, if any, which he or she made to obtain the desired action from the directors and the reasons for failure to obtain such action or not making such an effort—has the effect of requiring disputes relating to corporate management to be resolved by the directors.[22] Accordingly, cases decided under Rule 23.1 are relevant to the decision in this case, although the court below—because of its rule of presumptive disqualification—chose to ignore such decisions.

The courts have held that the pleading requirement of Rule 23.1 "represents a deliberate departure from the re-

[20] Rule 23.1, Fed. R. Civ. Proc., entitled "Derivative Actions by Shareholders," provides, in pertinent part:

> "In a derivative action brought by one or more shareholders . . . to enforce a right of a corporation . . . the corporation . . . having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege . . . with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and, if necessary, from the shareholders . . . and the reasons for his failure to obtain the action or for not making the effort. . . ."

[21] *See, e.g.*, In re Kauffman Mutual Fund Actions, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); Meyers v. Keeler, 414 F. Supp. 935, 938 (W.D. Okla. 1976); 3B J. Moore, *supra*, ¶ 23.1.15[4]; 7A C. Wright & A. Miller, Federal Practice and Procedure: Civil § 1832 (1972 ed.); Comment, 44 U.Chi.L.Rev., *supra*, at 171; Note, *Demand on Directors and Shareholders as a Prerequisite To A Derivative Suit,* 73 Harv.L.Rev. 746, 759 (1960).

[22] Professor Moore has observed that "[t]here is no unanimity of opinion among the courts, and probably the most straightforward approach is to admit frankly that it lies within the sound discretion of the court to determine the necessity for a demand." 3B J. Moore, Federal Practice, ¶ 23.1.19, at p. 23.1-83 (2d ed. 1978). *Compare,* Kauffman, *supra,* and Heit v. Baird, 567 F.2d 1157 (1st Cir. 1977) *with* deHaas v. Empire Petroleum Co., 286 F. Supp. 809 (D. Colo. 1968), *aff'd in part and vacated in part,* 435 F.2d 1223, 1228 (10th Cir. 1970) ("[c]ourts have generally been lenient in excusing demand") *and* Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971).

laxed policy of 'notice' pleading promoted elsewhere in the Federal Rules," *Heit* v. *Baird, supra,* 567 F.2d at 1160, and that the Rule "places an initial burden on the stockholder 'to demonstrate why the directors are incapable of doing their duty,' and failure to meet this burden requires dismissal of the suit." *Id.* (citation omitted). *See also Kauffman, supra,* 479 F.2d at 263. This Court has stated that demand will be excused only upon a showing of "extraordinary conditions," *Ross* v. *Bernhard, supra,* 396 U.S. at 534, and many courts have been exceedingly skeptical about accepting conclusory allegations, such as those employed by plaintiffs in their complaint in this case, *see* A. 50-51, as sufficient to explain why a demand on the directors would be futile.[23] Moreover, dismissal motions grounded upon Rule 23.1 have been successful in instances where: (1) a majority of the board of a corporation was not shown to be disabled from passing on the questions presented[24]; or (2) the composition of the board had changed significantly between the time either when the cause of action arose, when a previous demand was rejected, or when a complaint was filed, and the time of moving for dismissal.[25]

[23] The allegation that Fundamental's board "failed to take action" is squarely contradicted by the board's institution of an action against Goldman, Sachs in late 1970 and its settlement for a substantial sum in 1974. *See* p. 5, *supra*. The other conclusory allegations could certainly be attacked on Rule 23.1 grounds as well. *See, e.g.*, Meyers v. Keeler, *supra,* 414 F. Supp. at 938; Brooks v. American Export Indus., Inc., 68 F.R.D. 506, 510 (S.D.N.Y. 1975) (fact that all directors named as defendants does not, in itself, excuse demand); Baffino v. Bradford, 57 F.R.D. 79 (D.Minn. 1972).

[24] *Kauffman, supra,* 479 F.2d at 264; *Heit, supra,* 567 F.2d at 1161; Abrams v. Mayflower Investors, Inc., 62 F.R.D. 361, 368-70 (N.D. Ill. 1974); Lerman v. ITB Management Corporation, 58 F.R.D. 153, 156-59 (D. Mass. 1973).

[25] Brody v. Chemical Bank, 482 F.2d 1111, 1114 (2d Cir.), *cert. denied,* 414 U.S. 1104 (1973), *on remand,* 66 F.R.D. 87, 89 (S.D.N.Y. 1974), *aff'd,* 517 F.2d 932, 934 (2d Cir. 1975); Independent Investor Protective League v. Saunders, 64 F.R.D. 564, 571 (E.D. Pa. 1974). *See also* Corey v. Independent Ice Co.,

All of this authority suggests that the court below reached the wrong result in stripping the independent quorum of the power to decide whether pursuit of plaintiffs' proposed claims was in the best interests of all of Fundamental's shareholders. The demand rule serves to assure that the directors of a corporation will have the opportunity to make such business judgments, and it is simply not consistent with the letter and spirit of that rule to presume that the directors will not fairly discharge their obligations in this regard. Indeed, in cases such as *Hawes, Dimpfell,* and *Corbus, supra,* this Court has made it clear that a board decision not to pursue a corporate claim after a demand is made will not be overturned unless the putative derivative plaintiff demonstrates that such decision was itself tainted by fraud, corruption, or gross bad faith—none of which are even arguably present here.

The Court of Appeals' presumption, of course, contradicts the results reached in these cases. Thus, it will simply breed confusion as to when a demand is or is not required. Moreover, future derivative plaintiffs will, we submit, draw upon the decision below in an effort to avoid altogether the demand requirement of Rule 23.1. Derivative plaintiffs have commonly employed the language of decisions discuss-

207 F. 459, 464 (D. Mass. 1913) (complaint alleging demand on directors nineteen months before filing suit should also allege that the same directors were presently in office to comply with the demand requirement); 7A C. Wright and A. Miller, Federal Practice and Procedure: Civil § 1831, at 377-78 (1972 ed.) ("if a substantial period has transpired between the demand and institution of the action, the court may insist on a second demand or proof that the directors or the nature of the claim have not changed"); 3B Moore's Federal Practice, *supra* ¶ 23.1.19, at 23.1-81-82 (1978 ed.) ("[F]rom the particular facts alleged, it must appear that a new board of directors has not been installed. . . . [A] shareholder's suit is to be resorted to as a last alternative, and . . . the corporation is given every possibility to sue in its own name").

In the present case, of course, the composition of Fundamental's board did change between the time the complaint was filed and the time the motion to dismiss was filed. That change occurred by means of the delegation of authority to the independent quorum.

ing the power of corporate directors to render binding business judgments in drafting their pleadings alleging that demand would be futile. At least in this sense, the language which the court below used to set forth and to support its presumption will—if this Court approves the result below—appear repeatedly in innumerable future derivative complaints explaining why demand on the board of directors should be excused. And, because of the way the court's presumption was expressed, this effect is likely to be quite severe.

There is nothing in the presumption, or in the assumption as to "human nature" upon which it is based, that confines its application to corporations which happen to be mutual funds. Thus, the presumption—if applied in future cases to publicly-held corporations generally—would make pointless asking the independent directors to decide whether to pursue a proposed corporate claim against another director. Moreover, given the presumption, there is no logical distinction between the facts presented here and situations where a board majority (*e.g.,* 60%) is independent; as long as some board members were allegedly involved in the acts complained of, those who were not involved would be under the same presumptive disability to pass fairly on the wisdom of the claims.[26] Rule 23.1 and the policies which it embodies have thus been emasculated, since there is little purpose in requiring a demand on independent directors who are disqualified as a matter of law from exercising their business judgment concerning the corporation's best interests.

[26] In such situations, paraphrasing the opinion below, the independent members of a board, albeit a majority, still "must constantly deal with [their management colleagues] in a spirit of accommodation," still "are compelled for the most part to rely on the information and expert advice provided by [the management] directors," and still receive compensation during their service on the board which "depends almost entirely on the establishment of satisfactory working arrangements between them and the [management directors] responsible for their selection." 567 F.2d at 1212.

Indeed, plaintiffs in shareholder derivative suits have already begun citing the opinion of the court below as a basis for opposing dismissal motions based on Rule 23.1. In *Untermeyer* v. *Fidelity Daily Income Trust,* 79 F.R.D. 36 (D. Mass), *rev'd,* 580 F.2d 22 (1st Cir. 1978), such a claim was rejected in the District Court on the strength of *Kauffman* and *Heit, supra.* The District Judge noted that, because the opinion below "does not address the requirement of demand on the board of directors, and comments that Rule 23.1 cases are inapposite," 79 F.R.D. at 46 n. 29, it is not strictly inconsistent with those earlier decisions of the First Circuit. The District Court, however, went on expressly to reject the presumption employed below: "To the extent that *Lasker* assumes the independent directors to be captive to the will of the interested directors, this court disagrees." *Id.*[37]

Further, in at least one case, *Auerbach* v. *Bennett,* 64 A.D.2d 98, 408 N.Y.S.2d 83 (2d Dept. 1978), the decision below was the principal support for reversal of a grant of summary judgment dismissing a derivative suit filed by a shareholder of an ordinary business corporation. Although the corporation's board, in the exercise of its business judgment, had decided to seek dismissal of the case, the state court held that discovery should proceed. In response to the corporation's argument that the Court of Appeals' decision in the instant case should be confined to cases involving mutual funds, the *Auerbach* court stated that: "We do not perceive that the fiduciary duties of the directors of a business corporation differ substantially from the duties of directors of a mutual fund." 64 A.D.2d at 108 n. 6, 408 N.Y.S.2d at 88 n. 6.

[37] We question the *Untermeyer* District Court's attempt to distinguish the opinion below. In our view, application of the presumption to facts such as those in *Kauffman* and *Heit, supra,* where complaints were held deficient because they did not show that majorities of the boards were disabled from exercising their business judgment, might well call for different results in those cases.

The decision of the First Circuit reversing the District Court does not discuss the presumption *per se.*

The thrust of plaintiffs' argument throughout this case has been that many of the business judgment decisions discussed herein are inapplicable because they were cases in which a board of directors, after receiving a demand, chose not to pursue a cause of action proposed by a shareholder, or in which the shareholder-plaintiff unsuccessfully contended that demand was excused. Since Fundamental did not attack the complaint on Rule 23.1 grounds, plaintiffs characterize this case as a "validly commenced derivative action which has proceeded beyond the threshold issue of demand," and contend that the board no longer has a role to play with respect to it. Plaintiffs' Brief in Opposition to the Petition herein at 5.

That argument begs the question. If such an argument were accepted, it would follow that the *only* opportunity that the independent members of a corporate board have to pass on whether a proposed cause of action is in the corporation's best interests is if the putative plaintiffs and their counsel are so careless as to make a demand of the board before filing suit—a step which the presumption itself makes it easier to avoid. The demand rule itself confers no such talismanic immunity upon a derivative plaintiff, and the rationale upon which it is based argues for a continuing role for the board with respect to the conduct of derivative litigation. The powers of the board in such circumstances are determined by reference to state law, not by reference to an unsupported presumption as to "human nature." *See also* note 25, *supra,* and accompanying text.

It is unnecessary and indeed unwise to risk these consequences by affirming the Court of Appeals' decision. The District Court's approach in this case, as we urge above, has a far stronger basis in law, policy and logic, for it preserves the right of truly independent directors generally, and independent directors of mutual funds in particular, to resolve the question whether a claim should be

pursued, while permitting judicial evaluation of the limited issue of the directors' independence. "If a stockholder could compel the officers [of a corporation] to enforce every legal right, courts, instead of chosen officers, would be the arbiters of the corporation's fate." *Ashwander* v. *Tennessee Valley Authority,* 297 U.S. 288, 343 (1936) (Brandeis, J., concurring). By strengthening the hand of derivative plaintiffs in mutual fund litigation—and, by logical extension, in corporate litigation generally—the court below has necessarily expressed a preference for judicial resolution of such intracorporate disputes. That result—and the concomitant increase in complex federal court litigation—should be based on firmer footing than the vague presumption relied upon below.[28]

[28] As we have suggested in Point I, *supra,* the Court of Appeals' presumption is directly contrary to the legislative presumption underlying Section 144(a)(1) of the Delaware General Corporation Law which permits independent directors to approve transactions which may serve to benefit one or more of their colleagues on the board. Moreover, it conflicts with the general common law presumption that directors act honestly and in good faith to decide issues committed to their discretion. *See* Corbus, *supra,* 187 U.S. at 463; Robinson v. Pittsburgh Oil Ref. Corp., 14 Del. Ch. 193, 199, 126 A. 46, 48 (1924). Finally, as suggested in Point III, *infra,* the presumption conflicts with that drawn by Congress in stressing the role of independent directors in the Investment Company Act of 1940 and the amendments thereto.

Quite aside from these considerations, this Court has often condemned the use of blanket presumptions as a substitute for more searching inquiry. In *Vlandis v. Kline,* 412 U.S. 441, 446 (1973), this Court stated that such presumptions "have long been disfavored under the Due Process Clauses of the Fifth and Fourteenth Amendments." The principal reason is the unfairness of employing a "permanent and irrebuttable presumption . . . [which] is not necessarily or universally true in fact" where there are "reasonable alternative means of making the crucial determination." *Id.* at 452. *See also* Cleveland Bd. of Education v. La Fleur, 414 U.S. 632, 644-45 (1974). While we are of course not urging a constitutional claim in this case, the principles underlying this Court's skepticism about irrebuttable presumptions serve equally well here. As we show in Point II C and D below, the Court of Appeals' presumption seems to us to lack factual and logical bases and the District Court's inquiry into the deciding directors' *bona fides* provided a "reasonable alternative means of making the crucial determination." 412 U.S. at 452.

C. The Presumption Has No Factual or Logical Basis

Although we believe the result reached by the Court of Appeals is unwise, it might be tolerable if the factors upon which that court based its presumption could be said to promote fairness or provide significant protection to investors. Accordingly, we turn to a brief analysis of the three factors relied upon below.

First, the court observed that the directors who constituted the independent quorum had an ongoing relationship with their fellow directors and "must constantly deal with interested directors in a spirit of accommodation." 567 F.2d at 1212. This is a curious basis upon which to presume that the independent quorum should be stripped of responsibility for deciding whether pursuit of a lawsuit directed in part at the other directors serves the best interests of all the shareholders. The reasoning is, at best, circular. The current policy emphasis on increasing the number of independent directors serving on corporate boards is based in significant part on the theory that by developing such working relationships with the "inside" or "management" directors, the independent directors will best be able to fulfill their function of assisting in the sound management of the firm. The Business Roundtable recently issued a statement endorsing the increasing prevalence of outside directors. In discussing the appropriate relationship between the board (including, of course, its outside directors) and the chief executive officer (the quintessential inside director), that statement observed:

> "First, the relation between board and the chief executive officer should be challenging yet supportive and positive. It should be arm's length but not adversary. The board should stimulate management to perform at the peak of its capacity not by carping, but by setting high standards and providing level-headed encouragement. Communication, collaboration and mutual confidence should be objectives.

"Second, the atmosphere in the board room ought to be one of free and open discussion. This is the case now in many corporations. Strong, independent directors, well informed on the problems to be discussed, openly debate the pros and cons of questions presented. The atmosphere, set principally by the board chairman, encourages—rather than discourages—debate on the advantages of alternative courses of action. The information system provides a factual basis for that discussion. Searching questions are welcomed. The strong chief executive officer seeks the best judgment of his independent, strong, informed directors to maximize the soundness of board decisions." Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation,* 33 Bus. Law. 2083, 2110-11 (1978).[29]

We submit that it is manifestly inconsistent to encourage, on the one hand, the addition of independent directors to corporate boards and the development of close working relationships between such directors and their management-related brethren, and to employ, on the other, the existence of such relationships as a basis upon which to presume that the independent directors lack the strength of character to make hard choices when necessary.

A second basis for the court's presumption was its observation that the independent directors had to "rely on the

[29] *See also* Leech & Mundheim, *supra:*

"The identification of monitoring as the central role for outside directors does not detract from the value of the board or of individual members as advisers or consultants to management or as the avenue for obtaining resources or information that would be useful to the corporation. Moreover, . . . outside directors share with their insider counterparts on the board the responsibility for setting the goals of the corporation. An ideal group of outside directors would provide these services to the corporation while at the same time performing the vital monitoring function." 31 Bus. Law. at 1806.

information and expert advice provided by the adviser and the majority directors" during their service on the board. 567 F.2d at 1212. This factor is obviously related to the first, and is subject to the same criticism. Moreover, in both the mutual fund and general corporate contexts, the law is clear that the other members of the board and corporate management are under a legal duty to provide the members of the independent quorum and their counsel with complete and accurate information upon which to base a decision committed to their judgment. *See, e.g., Moses* v. *Burgin,* 445 F.2d 369, 376 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971); *Fogel* v. *Chestnutt, supra,* 533 F.2d at 745; *Tannenbaum* v. *Zeller,* 552 F.2d 402, 417 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977); Del. Code, tit. 8, § 144 (a)(1) (1975). If there had been a breach of this duty, the independent quorum's determination would not be entitled to the deference accorded under the business judgment rule, but there was no such breach in this case.

The final factor which the court below cited in support of its presumption was that the independent quorum's continued receipt of directors' compensation, ranging here "from $11,000 to $13,000 *per annum,* depends almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection." 567 F.2d at 1212.[30] This factor is also mired in circular reasoning, for it is generally urged that independent directors must be well compensated in order both to encourage strong, competent individuals to accept

[30] According to the record, the maximum annual compensation of the independent directors ranged from $11,025 to $12,500. (R. 233A-240A). This compensation was, however, attributable to service on the boards of more than one of the Anchor group of funds, not solely on service on Fundamental's board. With respect to the selection of directors, the record shows that all members of the independent quorum who acted in this case were suggested for nomination by a Director's Qualification Committee of which, at all times, a majority (two out of three members) consisted of statutorily disinterested directors under the Investment Company Act. (A. 143, 163; R. 195A).

such directorships in the first place, and to assure that such directors, once on the board, will spend the considerable time necessary to fulfill properly their obligations to the shareholders. *See* Leech & Mundheim, *supra*, 31 Bus. Law at 1831-1833; Cohen, *supra*, 34 Wash. & Lee L. Rev. at 849; D.S. Ruder, Report on Symposium Held at Harvard Business School: The Role and Composition of the Board of Directors of a Large Publicly Held Corporation at 7 (May 25, 1977). Moreover, the compensation paid directors in this case is hardly exorbitant. A recent survey of directors' compensation shows that the median annual compensation level for outside directors of financial companies was $6,300 per annum, while in other non-manufacturing and manufacturing concerns the levels were $7,000 and $9,300 per annum. Further, in larger companies with over $3 billion in assets (or the equivalent in sales), the survey revealed median annual compensation levels for financial companies, non-manufacturing companies and manufacturing companies of $12,000, $15,500 and $17,500, respectively. The Conference Board, *Corporate Directorship Practices: Compensation 1977* at viii (1978). Finally, other courts have rejected similar claims as a basis for questioning the exercise of directorial judgment.[31]

In sum, the factors underpinning the Court of Appeals' presumption do not support the drastic result reached

[31] In *Warshaw* v. *Calhoun*, 43 Del. Ch. 148, 158, 221 A.2d 487, 493 (1966), for example, the court stated:

> "We think the mere statement of fact of salary payments . . . to some of the [defendant company] directors does not, in itself, overcome the presumption of good faith accorded to the acts of directors."

And in *Reserve Management Corp.* v. *Anchor Daily Income Fund*, [1978] Fed. Sec. L. Rep. (CCH) ¶96,566 at 94374 n.12 (S.D.N.Y. 1978), the court rejected such an argument directed at the same independent directors whose judgment is questioned in this case, stating: "To get persons of solid business judgment to serve [as independent directors] without some compensation would be impractical and is more than Congress required. Moreover, persons of such standing would not ordinarily sell their souls for a pittance. . . ."

here. Indeed, the present chairman of the Securities and Exchange Commission, Harold M. Williams, a vigorous proponent of independent boards of directors, recently expressed a view wholly at odds with the notion that a legal presumption is the appropriate way to judge the ability of independent directors fairly to decide issues. Arguing in favor of recent S.E.C. proposals to require increased disclosure concerning the affiliations of actual and prospective board members with corporate management,[32] Chairman Williams stated:

> "I agree that an individual's merit as a director turns more on intangibles than on conformity with objective criteria aimed at measuring independence. While the capability of rendering independent judgment is, in the final analysis, a qualitative matter which cannot definitively be described in proxy material, the nature and extent of a director's relationship with the company and its management certainly bear upon both the fact and the appearance of independence." Letter to the Editor, Harold M. Williams, The Wall Street Journal, November 2, 1978, at 22, col. 4.

We submit that the District Court, which eschewed reliance on "objective criteria" in favor of findings of fact based on a review of the "qualitative" evidence concerning the independence and good faith of the deciding directors in this case, struck the proper balance between fairness to all of Fundamental's shareholders and the authority of its board to guard their interests.

D. The Court of Appeals' "Frivolous Case" Exception to Its Rule of Presumptive Disqualification Is Not an Adequate Substitute For the District Court's Careful Factual Inquiry Concerning the Independent Quorum's Decision

In the instant case, the court below sought to ameliorate the harshness of its new rule of presumptive

[32] The proposed S.E.C. rules concerning such disclosures are set forth in 43 Fed. Reg. 31,945 (July 24, 1978).

disqualification by suggesting that it should only apply to. "non-frivolous" actions. 567 F.2d at 1212. Although not specifically defined, the court apparently regarded "non-frivolous" cases as those in which it could not "say that, following a trial on the merits, the defendants would be found free from liability." *Id.* at 1210.

Because the court thought that at least one of the plaintiffs' claims might possibly succeed after trial, it was willing to presume that the independent quorum lacked the capacity to weigh the benefits of pursuing those claims against the disadvantages which such a course of action would entail. Thus, even the court's attempt to limit the reach of the presumption serves to increase the potential for excessive derivative litigation created by the decision below, for it ignores the numerous business factors—unrelated to the legal merits of a proposed suit—which this and other courts have frequently recognized as appropriate to a prudent decision as to whether or not a corporate claim should be pursued.[33] In our view, the pertinent case law counsels an approach such as that employed by the District Court. By elevating evaluation of the legal merits of the proposed derivative claim to a pre-eminent position in any analysis of an exercise of business judgment by corporate directors, the court below once again significantly undercut the very purpose of the business judgment rule.

Several cases decided subsequent to the Court of Appeals' opinion herein have refused to follow the approach of the court below, preferring instead an inquiry such as

[33] *See, e.g., Corbus, supra,* 187 U.S. at 463; Bernstein v. Mediobanca di Credito, 69 F.R.D. 592, 597 (S.D.N.Y. 1974); Puma v. Marriott, *supra;* Findley v. Garrett, 109 Cal.App.2d 166, 174, 240 P.2d 421, 426 (1952); Goodwin v. Castleton, 19 Wash.2d 748, 764, 144 P.2d 725, 733 (1944). *See also* note 12, *supra.* This result also conflicts with the Second Circuit's own prior precedent in *Fogel* v. *Chestnutt, supra,* where a different panel of that court stated that the performance of statutory duties by mutual fund independent directors required them to evaluate both "legal difficulties" and "economic pros and cons." 533 F.2d at 749-50.

that conducted by Judge Werker. In *Cramer* v. *General Telephone & Electronics Corp.,* 582 F.2d 259 (3d Cir. 1978), a derivative suit was filed seeking recovery from some directors and the auditors of GTE, a business corporation, of allegedly improper payments made to foreign governmental officials and private parties. About two months before Cramer's complaint was filed, GTE's board formed a Special Litigation Committee composed of independent directors to determine whether or not to pursue two other derivative suits that had been filed immediately after the improper payments had been disclosed. The Committee, relying on advice from independent counsel, determined that prosecuting the actions was not in GTE's best interests, and the board ultimately decided to seek dismissal of all three derivative suits. In *Cramer,* the Court of Appeals for the Third Circuit affirmed dismissal of plaintiff's claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder on the ground of failure to make demand as required by Rule 23.1. Although the District Court had not relied on the business judgment of the Special Litigation Committee in dismissing these claims, the Court of Appeals discussed that issue.

The court first observed that the business judgment rule "as a bar to a shareholder's derivative action is inextricably linked to the requirement in a number of jurisdictions that the plaintiff-shareholder first make a demand on the directors to pursue the claim" so that "the directors are then able to determine whether in their opinion a suit on behalf of the corporation would comport with the best interests of the corporation." 582 F.2d at 274-75 (citations omitted). After reciting the policies which support both the business judgment rule and the demand requirement of Rule 23.1, the court stated, in *dictum,* that:

> "[W]hile the demand requirement . . . should be rigorously enforced, we do not think that the business judgment of the directors should be totally insulated from

judicial review. In order for the directors' judgment to merit judicial deference, that judgment must have been made in good faith and independently of any influence of those persons suspected of wrongdoing. In addition, where the shareholder contends that the directors' judgment is so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion, a court should, we think, be able to conduct its own analysis of the reasonableness of that business judgment. *Id.* at 275.

In a second case arising out of GTE's foreign payments difficulties, an intermediate state appellate court in New York, relying upon the Court of Appeals' decision below, reversed a grant of summary judgment in favor of GTE and ordered further discovery proceedings, stating that:

> "[T]he business judgment rule should not be so rigorously applied as to cut short practically at the pleading stage an apparently legitimate inquiry into a nonfrivolous claim of wrongdoing by directors and officers on the ground that a committee of disinterested directors, acting on the advice of independent counsel, decided that the corporate interests will not be promoted by a derivative action. That is not to say that after the usual discovery and deposition stages of the action have been completed, summary judgment might not be the appropriate vehicle to terminate the action when the record shows that the disinterest of the directors was not refuted, the underlying facts were thoroughly investigated and cogent reasons existed in support of the decision of the committee." *Auerbach* v. *Bennett, supra,* 64 A.D.2d at 108, 408 N.Y.S.2d at 88.

These cases illustrate several significant ramifications of the decision of the court below. First, as we have suggested, the Court of Appeals' decision in the instant case is likely to be extended beyond the bounds of the mutual

fund industry, largely because the transaction which plaintiffs here sought to attack was merely an unsuccessful investment rather than one arising from the fact that mutual funds are affiliated with their advisers, and because the presumption employed to discredit the independent quorum's decision is not logically confined to the mutual fund context. Second, and more important, in both of these decisions the courts were reluctant to adopt any type of presumption, but rather suggested that the proper approach in cases like this is to permit discovery concerning the independent directors' decision focusing on: (1) their independence; (2) their good faith; (3) the procedures they employed in reaching their decision; and (4) the reasons for their decision. The District Court herein conducted just such an inquiry, and its careful handling of the issue merits affirmance by this Court.

After affording plaintiffs extensive discovery, the District Court reached a number of factual conclusions. First, it found that the members of the independent quorum in fact acted independently. 426 F. Supp. at 849. Second, it found that the quorum's decision was made in good faith, a conclusion which the Court of Appeals expressly accepted. 426 F. Supp. at 852; *see* 404 F. Supp. at 1180. Third, the District Court discussed at some length the procedures employed by the independent quorum, including the use of independent special counsel, the series of consultations and meetings held by the members of the independent quorum in reaching their decision, the breadth of their inquiry, and the fact that both the quorum of deciding directors and Judge Fuld received full and accurate information from the defendants with regard to their inquiry. 404 F. Supp. at 1175-77. Fourth, the District Court observed that:

> "[E]ven if the defendants are required as a matter of law to negate any suggestion of unfairness arising from the decision to abandon the derivative claims . . . they have done so. The exhibits presented to the court

on both the earlier motion to dismiss and the instant motion show that the minority directors carefully evaluated the opinions tendered by both counsel involved in this action, that they considered the merits of the derivative claims asserted in the complaint, that they discussed the facts and circumstances surrounding the purchase and retention of the notes with several of the defendant directors and that they communicated extensively among themselves before reaching a decision to seek dismissal of this suit." 426 F. Supp. at 852.

In other words, the District Court's decision fully satisfied the criteria spelled out in *dicta* in *Cramer* and *Auerbach,* and the court's deference to the independent quorum's decision under the business judgment rule was thus fully justified. One error in the Court of Appeals' approach below, as we have suggested, lay in disregarding these criteria because it could not "say that, following a trial on the merits, the defendants would be found free from liability for the Fund's losses." 567 F.2d at 1210.

Even if that be so, and Judge Fuld certainly concluded otherwise, this observation would only be relevant to the decision in a case such as this if the correctness *vel non* of the reasons which the independent quorum relied upon in reaching its decision was properly an issue, and that is simply not the case. The reasons relied upon are certainly relevant, but only in the following sense: If those reasons bore no relationship whatsoever to the decision reached, that fact would of course cast doubt upon the independence and good faith of the deciding directors.[34] The District

---

[34] Similarly, if the independent directors selected counsel to assist in their deliberations who was manifestly incompetent to give the kind of advice sought or who was embroiled in a conflict of interest with respect to such advice, that too would bear on resolution of the questions of independence and good faith. *See* Fogel v. Chestnutt, *supra,* 533 F.2d at 749-50; Leech & Mundheim, *supra,* 31 Bus. Law at 1822-23.

Court clearly recognized this. In rejecting plaintiffs' argument that defendant Haire (Anchor's chairman) had taken confusing and inconsistent positions with respect to whether, if this suit continued, Fundamental would have to secure a new investment adviser—one of the many factors which the independent quorum relied upon—Judge Werker stated that "[e]ven if the minority directors erred in this determination, . . . the court cannot upset their reasoned judgment without some showing that the independence of the disinterested quorum was impermissibly curtailed. The plaintiffs have not presented any such evidence." (A. 35). The relevant case law is fully in accord.

Detailed examination of the factors upon which independent directors rely in reaching a management decision is wholly inconsistent with the business judgment rule as it has been understood in this Court and in the lower federal and state courts. *See Corbus, supra,* 187 U.S. at 463; *United Copper Securities Co., supra,* 244 U.S. at 263-64; *Ashwander, supra,* 297 U.S. at 343 (Brandeis, J., concurring) ("[Stockholders] cannot secure the aid of a court to correct what appear to them to be mistakes of judgment on the part of the officers. Courts may not interfere with the management of the corporation, unless there is bad faith, disregard of the relative rights of its members, or other action seriously threatening their property rights. This rule applies whether the mistake is due to an error of fact or of law, or merely to bad business judgment. It applies, among other things, where the mistake alleged is the refusal to assert a seemingly clear cause of action, or the compromise of it"); *Pollitz* v. *Wabash Railroad Co.,* 207 N.Y. 113, 124, 100 N.E. 721, 724 (1912); *Chelrob* v. *Barrett,* 293 N.Y. 442, 460, 57 N.E.2d 825, 833 (1944); *Glassberg* v. *Boyd,* 35 Del. Ch. 293, 308, 116 A.2d 711, 720 (1955); *Puma* v. *Marriott, supra,* 283 A.2d at 696; *Issner* v. *Aldrich,* 254 F. Supp. 696, 699-700 (D. Del. 1966). Moreover, as Judge Aldrich stated in his discussion of the demand rule in *Kauffman, supra,* requiring a full-

fledged inquiry into the correctness *vel non* of the reasons underlying a business judgment by independent directors would allow a derivative plaintiff to "try the case on the merits . . . to show that he had a right to bring it." 479 F.2d at 265 (footnote omitted). Such a result is certainly unsound, if for no other reason than its impact on the workload of the federal courts.

Finally, the Second Circuit's own decision in *Tannenbaum, supra,* a leading case concerning the power of independent mutual fund directors, supports the District Court's approach herein. Although the opinion is somewhat ambiguous, the court there refused to be drawn into a discussion of specific criticisms concerning the directors' reasons for reaching a decision committed to their business judgment, 552 F.2d at 428, and held that:

> "It should be borne in mind that the question here is not whether, as a matter of hindsight, the determination of the independent directors was correct. The question is whether the decisions by these directors to forego recapture were reasonable considered at the time and under the circumstances in which they were reached.
>
> "We conclude that the *Fogel* test governing the determination of the independent directors not to recapture was satisfied in this case. There was full disclosure by the Fund's adviser as to the possibilities of recapture and the methods available to accomplish it. All material dealing with the question was placed before the independent directors and fully considered by them. They were correctly advised by counsel as to the applicable legal standards. They carefully weighed the relative advantages and disadvantages of recapture and the economic pros and cons involved. Their decision to forego recapture was a reasonable business judgment." *Id.* at 428-29 (footnote omitted).

Thus, the court in *Tannenbaum* limited its inquiry to an assessment of the kinds of things that the independent directors did in reaching their decision, rather than to the correctness of the reasons upon which they relied. As we have shown, Judge Werker met this standard, and his careful factual assessment of the independent quorum's decision is more likely to assure fairness to all of Fundamental's shareholders than is the presumption employed by the Court of Appeals.

In the concluding section of this brief we show that there is nothing in the framework of statutory and decisional law applicable to mutual funds which supports the creation of such a presumption, even if its effects could somehow be limited to the mutual fund context. Indeed, we demonstrate that the court drew precisely the *opposite* conclusion from that intended by the Investment Company Act, with the result that the opinion below places independent directors of mutual funds under a special disability in attempting to exercise the "watchdog" function expressly intended for them by Congress and confirmed by previous decisions in both the First and Second Circuits.

III.

The Court of Appeals Misconstrued Provisions of the Investment Company Act Governing the Duties of Mutual Fund Independent Directors

The decision below conflicts with prior interpretations of the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*, in both the First and Second Circuits. The interpretation which the Court of Appeals gave to the Investment Company Act is of critical importance to its decision because the framework of the Act was said to provide one basis for departing from what the court acknowledged was a "plethora" of cases upholding "the powers of boards of directors to terminate stockholder derivative suits." 567 F.2d at 1212 n. 14.[35]

On more than one occasion this Court has stated that the *only* circumstance under which it would be willing to uphold interference with the state law of corporate governance is "where federal law expressly requires [it]," *Cort* v. *Ash, supra*, 422 U.S. at 84; *Santa Fe Industries,*

[35] Nine such decisions, including four by this Court, were cited by the District Court. 404 F. Supp. at 1179. The court below also offered as a basis for its decision what is described as "the unique nature of the investment company and its symbiotic relationship with its investment adviser," 567 F.2d at 1212 n. 14. The link between this observation and the presumption which the court employed was never explained. Although we believe that application of the presumption cannot logically be confined to corporations which happen to be mutual funds, *see* Point II, *supra*, our position is that, assuming *arguendo* such a limitation exists, the court below erred in the conclusion it drew based on the Investment Company Act of 1940. Moreover, the court failed to examine what significance, if any, such a "symbiotic relationship" might have under controlling state law. *See* Point I, *supra*. The District Court had found the controlling law on this question to be that "absent a showing of improper motive they [the independent directors] have always been permitted to apply their business judgment to decisions involving derivative suits against the [affiliated] corporations they serve," citing *Warshaw* v. *Calhoun*, 43 Del.Ch. 148, 221 A.2d 487 (1966). *See* 426 F. Supp. at 849.

Inc. v. *Green, supra*, 430 U.S. at 479. This Court has never found such a situation to have occurred, and there is clearly no provision of the Investment Company Act, express or otherwise, which satisfies that test. Indeed, the Court of Appeals did precisely what *Santa Fe* directs the federal courts not to do. By sweeping aside "established state policies of corporate regulation" the decision herein would "federalize" a "substantial portion of the law of corporations" in the complete absence of anything even resembling a "clear indication of congressional intent." 430 U.S. at 479.

The statutory provisions relied upon by the court below were those sections of the Investment Company Act which require 40% of the membership of mutual fund boards of directors to be unaffiliated with the fund's investment adviser, 15 U.S.C. §§ 80a-2(a)(3) and (19), 80a-10(a), and which provide for shareholder suits challenging the level of compensation provided for in the investment advisory contract, but seeking no other relief. 15 U.S.C. § 80a-35(b).

The legislative history of the 1970 amendments to these very sections, however, reveals Congress' intention to strengthen the standards for independence of mutual fund directors not affiliated with the investment adviser through the use of a newly defined term, "interested person."[36] Indeed, the Senate Report accompanying the 1970 amendment makes plain that even with respect to the specific issue addressed by the amendments—the level of investment advisory fees set by an adviser's contract with a fund—the new statutory language "is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors," S.Rep. No. 91-184, 91st Cong., 1st Sess. at 33 (1969), *reprinted in* [1970] U.S. Code Cong. & Admin. News 4897, 4903. Since the legislation relied upon by the court below was plainly intended not to supplant the business judgment rule even in the area

[36] *See* Reserve Management Corp. v. Anchor Daily Income Fund, [1978] Fed. Sec. L. Rep. (CCH) ¶ 96,566 at 94374 n. 11 (S.D.N.Y. Sept. 28, 1978).

of advisory fees where fund-adviser conflicts are most severe, *a fortiori* it can supply no basis for disenfranchising directors from control in other areas. Indeed, with respect to mutual fund governance generally the Senate Report states that:

> "The section [36(b)] is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary." S.Rep. No. 91-184 at 7.

Thus, far from supplying the necessary "clear indication of congressional intent" required by *Santa Fe* in order to displace state law, if anything the statutory sections relied upon by the Court of Appeals as the basis for its decision reveal a clear intent to the contrary.[37]

Even more remarkable is that another Circuit had previously found the same sections of the Investment Company Act to express Congress' intent to strengthen and enhance the exercise of independent directorial judgment, rather than to withdraw it. In *In re Kauffman Mutual Fund Actions, supra,* a decision not even cited by the court below, a mutual fund shareholder suing derivatively for his fund's benefit sought damages from the fund's investment adviser under the Investment Company and Clayton Acts for allegedly excessive advisory fees. There, as here, the shareholder claimed that the independent directors whose presence on the mutual fund board was mandated by the Investment Company Act were disqualified from exercising their business judgment as to the disposition of the proposed claims against the investment adviser because the adviser "dominated and controlled" the entire fund board. 479 F.2d at 262. The shareholder's claim that

[37] Interpretation of the federal securities laws in a manner opposite from or contrary to the intent of Congress, even by specialized agencies such as the Securities and Exchange Commission, is not unknown. *Cf.* SEC v. Sloan, 98 S.Ct. 1702, 1711-12 (1978).

demand on the directors was excused because different rules of directorial control of corporate affairs should be applied in light of the peculiarities of the Investment Company Act was emphatically rejected by the Court of Appeals for the First Circuit:

> "Nor do we think that an exception [to the demand rule] is to be made in the case of unaffiliated directors of a mutual fund on the ground that since they are expected to be sensitive to misconduct of this variety they are automatically incapacitated from performing their duties—their approval or acquiescence making them 'wrongdoers'—once a stockholder alleges a corporate injury stemming from the adviser-fund relationship. Apart from the fact that this, again, would enable a plaintiff to try his case on the merits in order to determine whether he had a right to bring it, it would be a misconception of the nature of unaffiliated directors. . . . We do not believe . . . that, as directors required to be disinterested in a particular transaction, they differ in their fiduciary obligations from disinterested directors in any other corporate venture. . . . To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it." 479 F.2d at 266-67.[38]

We submit that the *Kauffman* court's interpretation of the Investment Company Act is the correct one. Properly read, the Act supports the conclusion reached by the First Circuit that Congress did not intend to repeal well-established limitations upon the availability of stockholder derivative actions, and that an independent mutual fund

[38] Another indication that Congress intended disinterested directors to fulfill a "watchdog" role with respect to the interested directors is its decision not to incorporate into the Investment Company Act of 1940 a provision, proposed by the Securities and Exchange Commission, that would have forced investment companies to seek court approval before settling lawsuits against "insiders." Wolf v. Barkes, 348 F.2d 994, 997 n.4 (2d Cir. 1965).

director, just as any other corporate director, should have the power to decide whether pursuit of claims against the fund investment adviser is in the fund's best interests.

Moreover, the position of the court below conflicts with prior decisions within the Second Circuit. In *Fogel* v. *Chestnutt, supra,* decided in 1975, the Second Circuit held that the determination of independent mutual fund directors that the adviser should not pursue recapture of brokerage commissions would, as a matter of Investment Company Act policy, be respected as an exercise of business judgment provided those directors received full disclosure of potential fund-adviser conflicts. Given such disclosure, the independent directors' decision would serve to defeat a later derivative suit against the adviser because the directors were "exercis[ing] the independent judgment that Congress clearly intended," 533 F.2d at 745, *quoting Moses* v. *Burgin, supra,* 455 F.2d at 377, and their decision would be upheld as "a 'reasonable business judgment.'" *Id.* at 750. Similarly, in *Tannenbaum* v. *Zeller, supra,* a 1977 decision, the Second Circuit affirmed dismissal of a mutual fund breach of fiduciary duty claim raised derivatively by a shareholder against the investment adviser for failure to recapture brokerage commissions because the independent directors had, consistent with the *Fogel* test, exercised their business judgment to forego recapture. 552 F.2d at 418-19. With respect to Congressional intent, the *Tannenbaum* Court held that:

> "We have found nothing in the structure or legislative history of the Investment Company Act which indicates that Congress meant to remove the question of how best to use the [fiduciary monies sought to be recovered by the shareholder-plaintiff] from the informed discretion of the independent members of a mutual fund's board of directors." *Id.* at 417.

Therefore, at the very least, the decision below has resulted in an unsettled state of the law that is both con-

fusing to the mutual fund industry and unnecessarily disrupts the management of an important segment of our financial economy. The inevitable consequence of approval of the Court of Appeals' decision by this Court, even if that decision were confined to the mutual fund context, will be to shift both major and minor matters of mutual fund management—including, of course, the wisdom of literally thousands of investment decisions made by the funds—from the board room to the federal courtroom.

This result is surely not required by the Investment Company Act. Yet under the decision below, a single disgruntled shareholder who produces a complaint attacking some of the directors which can withstand a motion to dismiss can totally preempt the corporation's independent directors on the matter at issue, and can have the decision which he or she wishes to challenge reviewed in a plenary trial conducted in federal court. Unless this Court reverses that decision, the system of mutual fund management contemplated by Congress and previously implemented by the courts will become as anarchistic as the business judgment rule is democratic.

CONCLUSION

For the foregoing reasons, IDS respectfully prays that the judgment of the Second Circuit Court of Appeals be reversed and the case remanded for entry of judgment dismissing plaintiffs' complaint.

November 16, 1978

Respectfully submitted,

John E. Tobin
Roger W. Kapp
Richard H. Sayler
Robert J. Siverd
Attorneys for
Investors Diversified Services, Inc.
30 Rockefeller Plaza
New York, New York 10020

Donovan Leisure Newton &
Irvine

Joseph F. Grinnell
Senior Vice President and General Counsel
Investors Diversified Services, Inc.

Of Counsel

ADDENDUM

ADDENDUM

Statutes and Rules Involved

Delaware General Corporation Law

§ 141. Board of directors; powers; etc.

(a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

(b) The board of directors of a corporation shall consist of 1 or more members. The number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate. Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws. The certificate of incorporation or bylaws may prescribe other qualifications for directors. Each director shall hold office until his successor is elected and qualified or until his earlier resignation or removal. Any director may resign at any time upon written notice to the corporation. A majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the bylaws require a greater number. Unless the certificate of incorporation provides otherwise, the bylaws may provide that a number less than a majority shall constitute a quorum which in no case shall be less than ⅓ of

the total number of directors except that when a board of 1 director is authorized under the provisions of this section, then 1 director shall constitute a quorum. The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number.

• • •

§ 144. Interested directors; quorum.

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee thereof, or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction. (8 Del. C. 1953, § 144; 56 Del. Laws, c. 50; 56 Del. Laws, c. 186, § 5; 57 Del. Laws, c. 148, § 7.)

• • •

Investment Company Act of 1940

§ 10a Affiliations or interest of directors, officers, and employees

(a) No registered investment company shall have a board of directors more than 60 percentum of the members of which are persons who are interested persons of such registered company. Aug. 22, 1940, c. 686, Title I, § 10, 54 Stat. 806; Dec. 14, 1970, Pub. L. 91-547, § 5, 84 Stat. 1416.

§ 36 Breach of fiduciary duty—Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 1(b) of this title.

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this sub-

chapter for the purposes of sections 9 and 49 of this title, section 15 of the Securities Exchange Act of 1934, or section 203 of title II of this Act, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section. Aug. 22, 1940, c. 686, Title I, § 36, 54 Stat. 841; Dec. 14, 1970, Pub. L. 91-547, § 20, 84 Stat. 1428.

* * *

Federal Rules of Civil Procedure

Rule 23.1, Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Added Feb. 28, 1966, eff. July 1, 1966.